

# Political Origins and Implications of the Economic Crisis in Russia

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Russia's economic performance in the last 15 years has surprised observers at least three times. First was the Russian economic miracle of 1999–2008. According to the International Monetary Fund's *World Economic Outlook*, over these 10 years, Russia's per-capita gross domestic product (GDP) doubled in constant prices (equivalent to the average annual growth rate of 7 percent) and grew sixfold in nominal dollars—from \$270 billion to \$1.7 trillion in current prices.<sup>1</sup>

The second surprise was the catastrophic performance in 2008–09 during the global economic crisis. In 2009, Russia's GDP collapsed by 8 percent, more than that of any other large economy.

Finally is the recent economic slowdown turned crisis. After the Russian economy seemingly recovered from the global economic crisis—growing at 4 percent per year in 2010 and 2011—it started to stagnate. Even before the annexation of Crimea, Russian economic growth had slowed to zero. Despite solid macroeconomic fundamentals, robust growth in the US and China, better-than-expected performance of the eurozone economy, high oil prices, and the return of political stability under President Vladimir Putin (who promised serious pro-business reforms), the Russian economy stopped growing.

In this paper, I will not discuss the first two episodes.<sup>2</sup> Instead, I will focus on the postcrisis slowdown, which mushroomed into the current crisis. My goal is to explain the origins of the slowdown, understand its political implications, and analyze its interaction with the 2014 crisis in Crimea and eastern Ukraine.

I will first state that the economic miracle preceding the crisis was real—and so is the current slowdown. Second, I will show that the only explanation of the latter is the poor investment climate, which is an essential part of the current political equilibrium. Third, I will speculate that current economic conditions imply the need to depart from the social contract that prevailed during the economic miracle years. This social contract presumed that the public would give up its political freedoms in exchange for economic growth. The slowdown effectively destroyed this contract and, in doing so, may have contributed to the decision to turn to imperial ideology and territorial expansion. Finally, I will try to forecast what all of this means for the Russian economy and the world.

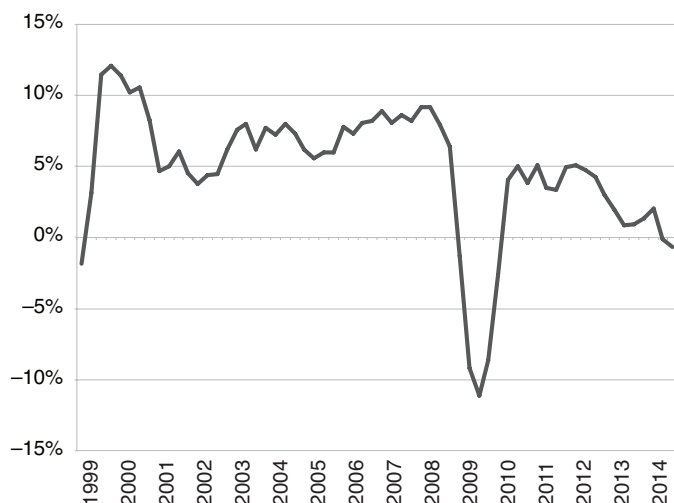
### **Russian Economic Miracle—and the New Stagnation**

In 1995, Daniel Yergin and Thane Gustafson wrote a book that contained three scenarios for Russia in 2010.<sup>3</sup> One of the scenarios was *chudo* (Russian for “miracle”). Another scenario included rebellions in frontier regions and ultimate disintegration, while the third scenario foresaw a grim military dictatorship bent on expansion.

As often happens, real life turned out to be a mix of the three scenarios. In terms of domestic and external politics, Russia eventually followed the latter two scenarios. On the other hand, the economic performance of 1999–2008 was indeed miraculous from both an international and historical perspective.<sup>4</sup> Despite the beating delivered by the global economic crisis, Russia was officially classified by the World Bank in 2013 as a high-income economy and was on track to join the Organisation for Economic Co-operation and Development (OECD, “the club of developed countries”).

As my focus here is the slowdown rather than the miracle, I will need only to rely on the following two takeaways from my and Aleh Tsyvinski’s analysis of the miracle years. First, this 1999–2008 growth was indeed impressive and trickled down to all parts of Russian society. Second, the sources of this growth—growth in commodity prices, cheap and abundant labor, underutilized production capacity, low-hanging fruit of macroeconomic stabilization,

FIGURE 1  
RUSSIAN GDP GROWTH, QUARTERLY DATA (YEAR-OVER-YEAR)



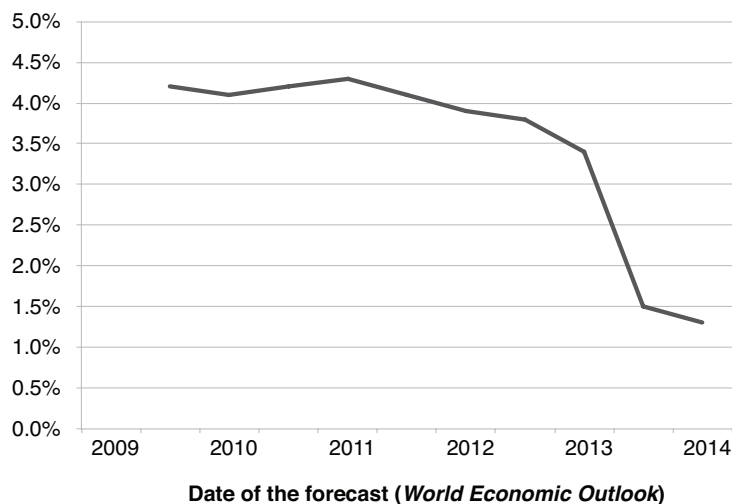
Sources: New Economic School and Renaissance Capital, *RenCap-NES Macro Monitor: Russia* (April 2014).

and first-generation institutional reforms of the 1990s and early 2000s—were by and large exhausted by 2008. Therefore, to continue the growth after the crisis, Russia needed to carry out substantial reforms to improve the protection of property rights, rule of law, and competition.

These reforms have not happened. After the postcrisis recovery, Russian growth rates fell substantially. Figure 1 presents quarterly GDP growth data, which show that the slowdown started in 2012. During the recovery in 2010 and 2011, the growth rates were above 4 percent, but in the second half of 2012 they fell to just 2 percent. The official GDP growth in 2013 was just 1.3 percent. The forecasts for the first half of 2014 entered negative territory even before the Crimean crisis.

One of the most interesting features of this slowdown is that it was a surprise to many observers. The *World Economic Outlook*, the

FIGURE 2  
RUSSIAN ECONOMIC GROWTH IN 2013 AS FORECASTED  
BY THE INTERNATIONAL MONETARY FUND



Source: *World Economic Outlook* (2009–14).

flagship biannual publication of the International Monetary Fund (IMF), consistently predicted the 3–4 percent growth in 2013 up until October 2013, when it reduced its forecast to 1.5 percent. (See figure 2.) Even though the slowdown started in the second half of 2012—right after Vladimir Putin returned as president after Dmitry Medvedev’s one term in office—the IMF was still predicting growth as high as 3.4 percent as recently as April 2013.

The IMF was certainly not alone—the 3–4 percent expected growth was the official forecast made by the Russian Ministry of the Economic Development that was revised only in Spring 2013. In January 2013, Prime Minister Dmitry Medvedev actually expressed his dissatisfaction with the fact that the growth forecast was too low and said that Russia needed 5 percent growth per year for the years to come. This is not a coincidence: in his programmatic January 2012 article “We Need a New Economy” and in his first economic decree

(no. 596), signed on his inauguration day, May 7, 2012, newly elected President Putin made a number of promises for the 2012–18 presidential term, all based on the 5–6 percent growth goal.

Only in the Fall 2013 did long-term stagnation become the essential part of the mainstream economic forecast. In October 2013, Minister of Economic Development Alexei Ulyukaev spoke of the baseline scenario of 2–3 percent annual growth for the years to come. And in May 2014 he finally acknowledged that Russia was in a “technical recession” (negative growth in two quarters in a row).<sup>5</sup>

### Why a Slowdown?

Why has Russian growth slowed down? Initially, the 2012–13 decline was blamed on the business cycle. The narrative was that the Russian economy was below its potential steady-state growth rate; hence, the government needed to increase spending to support weak aggregate demand. However, this explanation was not consistent with the data. Contrary to the textbook description of an economy in recession, the Russian economy was characterized by low unemployment (5.0–5.5 percent), high inflation (exceeding the official target of 6.0 percent), booming consumer credit (by 40 percent in 2012 and 30 percent in 2013), and robust growth in consumption (7.0 percent in 2012 and 3.5 percent in 2013).

These data eventually debunked the cyclical explanation, and the government recognized the structural nature of the slowdown. Yet, initially, it preferred to blame the structural problems on external factors. There have been two versions of this argument. First, the “West is weak” version argued that the Russian economy is strongly integrated into the global economy and therefore suffers from the crisis in the global economy and, in particular, in the West. The second version, on the contrary, was based on the “West is strong” theory: the West was not weak but was jealous and hostile to Russia and used its strength to undermine Russia’s reputation and, eventually, Russia’s successful development. Putin spokesperson Dmitry Peskov formulated it in the following terms: “strong, successful, wealthy and healthy—such as we are now—are often disliked by others.”<sup>6</sup>

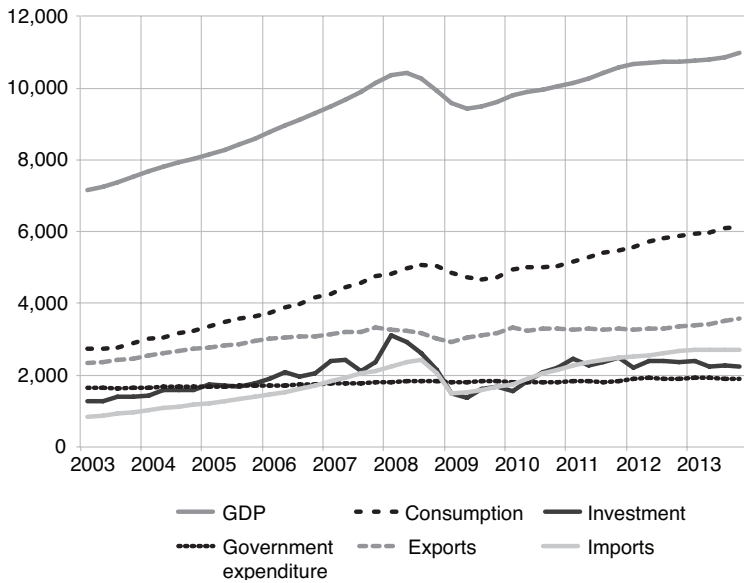
The first argument, relating the weakness of the Russian economy to that of the West, is also not consistent with the data. Unlike 2011 and the beginning of 2012, when the US and Europe indeed continued to struggle after the crisis, in the end of 2012 and in 2013, the US economy embarked on a solid recovery. While the European economy was and is still weak, it is doing much better than could have been expected in mid-2012 when the Russian slowdown started. Finally, none of the major emerging market economies had a substantial slowdown in 2013; most of them actually had a growth acceleration, and so did the global economy as a whole. Not surprisingly, oil prices remained at historically high levels.

The second argument is essentially a conspiracy theory and by definition cannot be refuted by data. It is, however, unlikely that we would have learned nothing about such an anti-Russian economic plan after Edward Snowden's and other leaks. Eventually even Putin himself, in his annual address to the Russian Parliament in December 2013, did acknowledge, "Let's be frank: the main reasons for the slowdown in our economy are internal rather than external in nature."<sup>7</sup>

What were the internal problems? Unlike its OECD counterparts, Russia was *not* suffering from a debt crisis. During the miracle years, Russia paid off virtually all foreign debt and even accumulated fiscal reserves. Currently, Russia's sovereign debt stands only at 10 percent of its GDP, and its two sovereign wealth funds (the Reserve Fund and the National Welfare Fund) add up to \$185 billion, also about 10 percent of GDP.

Therefore, we cannot explain the slowdown by Russia's macroeconomic problems. Figure 3 shows that the main source of Russia's economic decline was the fall of investment. Although the other components of Russia's GDP did not fall or recovered after the crisis, investment is still below its 2008 peak. This simple fact pinpoints a very intuitive explanation for the slowdown: Russia is no longer attractive for investors, neither foreign nor Russian. This explanation is also consistent with the fact that Russia experienced a net capital *outflow* of 3 percent of its GDP in 2012 and 2013. Also, Russian stocks were traded at about a 50 percent discount to other emerging markets even before Crimea.

FIGURE 3  
DYNAMICS OF RUSSIAN GDP AND ITS COMPONENTS IN 2003–13



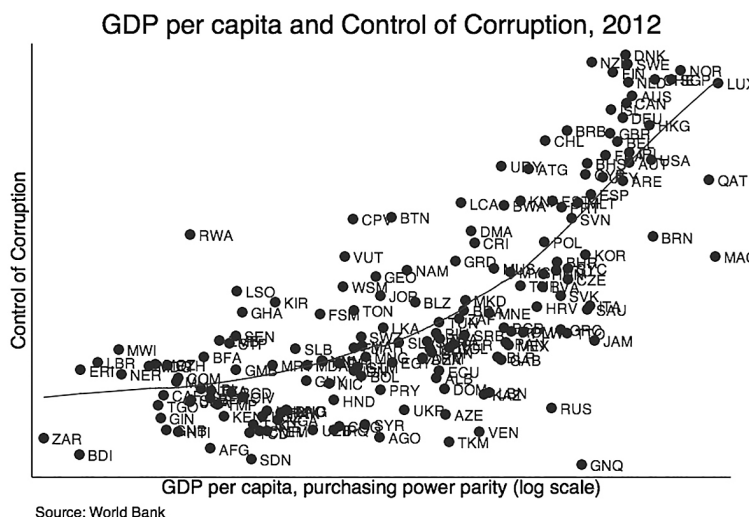
Note: Quarterly data, 2008 constant prices.

Source: Rosstat.

The investors are leaving Russia for a very simple reason: Russia's investment climate (the rule of law and protection of investors' rights) is very poor—at least relative to competing capital destinations. For a high-income, urbanized, and educated country, Russia is unusually corrupt. Figure 4 shows corruption and level of development around the world. In this graph, Russia is one standard deviation more corrupt than the countries with a similar level of development (East European and Latin American countries). The level of corruption in Russia is on par with that of the poorest countries in the world.

The unusually high level of corruption in Russia is hardly news to investors or to the Russian government. In particular, Putin flagged the investment climate and corruption in 2012 as the most important barriers to economic growth. However, what is new is the

FIGURE 4  
PER-CAPITA GDP AND CONTROL OF CORRUPTION (2012)



Note: The line represents a nonparametric trend. Control of corruption is higher in less-corrupt countries.

Source: World Bank, Worldwide Governance Indicators, and author's calculations.

Russian government's complete inability or unwillingness to tackle these problems and, consequently, investors' ultimate disillusionment with government promises. Now that other sources of growth such as rising commodity prices, cheap labor, and spare production capacity have been exhausted, growth in investment is unlikely without reform, and therefore, stagnation is inevitable.

Given that the government has recognized and discussed this so many times, why does Russia not reform? It is not because the government does not know what to do. The very same government has written many reform programs—from Gref Program 2001–2010 to Strategy 2020 and Putin's May 7, 2012, presidential decrees. However, these institutional reforms are now contrary to the interests of



the ruling elite. Rule of law and fighting corruption constrain the elite's ability to extract rents from the economy and, thus, to hold on to power. Although these reforms are likely to result in faster GDP growth and prosperity for the whole country, they will reduce the incumbent elite's ability to enjoy this prosperity.

Indeed, even if the opposition promises to preserve today's elites' wealth after the change of political power, it is not clear how the opposition could credibly commit to respecting this promise. This conundrum is formulated by Daron Acemoglu as the absence of the Political Coase Theorem.<sup>8</sup> Politics are different from the corporate world, where the more efficient investor can take over an inefficient company by simply paying out the existing shareholders (the economic version of the Coase Theorem). By definition, in politics, there is no external enforcement of contracts between outgoing and incoming elites, especially in countries without strong and legitimate political and legal institutions. In such countries, the enforcement ultimately depends on the party in power.

This problem is the key explanation of the Russian elite's preference for the status quo. The elite chooses to avoid institutional reforms that may raise the probability of political transition. Moreover, high oil prices, and therefore substantial resource rents, further increase aversion to reforms by making incentives for staying in control even higher.

The situation is therefore very close to the Brezhnevist *zastoi* (literally, "stagnation"), the last period of Soviet history when high oil prices resulted in a lack of economic dynamism in the Soviet Union. Important economic reforms were delayed, economic growth disappeared, and once oil prices went down in the mid-1980s—the Soviet Union went bankrupt and disintegrated.<sup>9</sup>

Tsyvinski and I predicted that these risks may materialize in post-crisis Russia as well and described a "70–80" scenario.<sup>10</sup> When oil prices were at \$40 per barrel, we argued that if prices would rise back to \$70–80 per barrel, then Russia would return to a 1970s–1980s style of stagnation, with Putin's approval ratings at 70–80 percent because of the spending of the petrodollars, but necessary reforms would be forgone. We made only a quantitative mistake in not

foreseeing that the price of oil would recover all the way to \$100 per barrel. Otherwise, the elite's effort at preserving Russia's political equilibrium is exactly like the 70–80 scenario predicted: high oil prices ensure sufficient rents for the elite to support the status quo, while promarket reforms would result in higher political and economic competition, increasing the likelihood of political change.

To sum up, the most plausible explanation of the slowdown is the deterioration of Russia's investment climate, which in turn is an essential part of maintaining a no-reform political equilibrium.

### **Political Implications of the Stagnation**

The economic stagnation has dramatic implications for the relations between the elites and public in Russia. Daniel Treisman carried out an empirical analysis of Russian monthly opinion polls for the Yeltsin and Putin years and showed that Russians' support for the incumbent president closely correlates with their perception of economic performance.<sup>11</sup> This analysis sheds light on the social contract of the miracle years. The government was corrupt and not accountable to the public. At the same time, the people were content with the material benefits afforded by the economic growth; therefore, only moderate censorship and repression were needed for the government to remain in power.

However, the very same argument implies that the 70–80 scenario is not sustainable in the long run. The lack of institutional reforms and proliferation of corruption destroy investment and growth, driving down public support for the regime. Therefore, the social contract of the miracle years is no longer feasible. To stay in power, the government has to choose one of two options. First, it can drastically increase transparency and accountability or follow the reform path, which is not consistent with the political imperatives of staying in power. The second option is to come up with a new ideology worth economic hardship or to drastically increase censorship and repression. The last of Yergin and Gustafson's scenarios—the “grim military dictatorship bent for territorial expansion”—is certainly the most obvious solution for this problem.<sup>12</sup>

We still do not fully understand why Russia decided to annex Crimea. Yet, this discussion implies that the economic slowdown is certainly one of the possible explanations—or, at least, a major contributing factor. In the end, very much in line with the government's expectations, the aggression in Ukraine did distract the public from the economic slowdown and raised Putin's approval ratings.

### **What Next?**

The Ukrainian adventure has had a substantial impact on Russian economy. Although the direct cost of supporting Crimea is just several billions dollars a year (less than half a percent of Russia's GDP), the threat of potential sanctions immediately affected investors' willingness to invest in Russia. Capital outflow accelerated (as of September 2014, the official forecast for 2014 net capital flight is an unprecedented \$100 billion, or more than 5 percent of annual GDP), the ruble fell to record lows against the dollar and the euro, and stagnation turned into a recession. In this sense, the sanctions hit the Russian economy in the most painful way: they aggravated country's most severe economic problem—the deteriorating investment climate.

The Ukrainian crisis also showed both foreign and Russian investors that investment and economic growth are not a top priority for the Russian government. Even though the government understood that the annexation of Crimea and further escalation in eastern Ukraine would result in international isolation and substantial costs from sanctions, it still made this decision. This has demonstrated that the Russian elite prefer to remain in power through imperialistic and nationalist ideology even if the latter is very costly to the economy.

This strategy, however, can work only if the citizens are not sufficiently informed about the economic costs—especially, about the long-term economic costs. This is why the aggression against Ukraine had to be accompanied by increased censorship and repression. The government stepped up censorship of the Internet and, especially, the blogosphere. The state also continued to harass the

key opposition leaders who disseminated information critical of the government.

Can such a system last until 2018, the end of Putin's current term in office? There are examples of nondemocratic regimes with censorship and repression that lasted not just for several years but for several decades. On one hand, Russia is rather rich, highly educated, and urbanized, so it is hard to control the dissemination of information and the activities of the political opposition. On the other hand, the regime is still powerful enough to bribe (or, if needed, intimidate) opposition political leaders within the country or in small countries outside Russia. So the system may indeed last for a long time. What is clear, however, is that continuation of the current political equilibrium will involve censorship and repression and will have a substantial negative impact on economic performance.

Another important tool of the regime in the coming years will continue to be its aggressive foreign policy. Economic hardship will be easier to justify in the presence of external enemies. In this sense, it is not impossible to have another Crimea, especially if the economic situation worsens.

Therefore, it is quite possible to foresee Russia in 2018 being a corrupt nondemocratic regime with a stagnating economy and aggressive foreign policy. On the other hand, nondemocratic regimes can fall apart overnight because of internal conflict among the elite or protests against economic hardships. The former is not impossible given that individual sanctions do impose tangible costs on members of the elite. The latter is also likely if the price of oil falls, or at least does not rise, and the government runs out of reserves.

## Conclusions

I have argued that the Russian economic slowdown was a natural implication of the political equilibrium in which elites prefer the status quo to institutional reforms. Although the reforms would result in a better investment climate and, therefore, economic growth, they would also endanger the elites' hold on power. Given the high resource rents and the resulting high stakes of staying in power, it

is not surprising that the Russian government preferred to continue with the status quo, in which corruption and expansion of state companies and politically connected businesspeople resulted in capital flight, reduced investment, and stagnation.

The slowdown has contributed to changes in domestic and foreign politics. Once economic growth was gone, the government could no longer rely on the social contract of 2000s, in which the elites were opportunistic, unaccountable, and corrupt but delivered material benefits to the public. Therefore, it had to come up with a new ideology or, at least, a reason to support the government that failed to produce economic growth. Annexing Crimea, and the accompanying imperialistic and nationalist discourse, are certainly a convenient distraction from Russia's economic problems.

The economic implications of the Crimean annexation and the larger Ukrainian crisis are substantial. The direct costs of military operations and the support of the Crimean economy are limited and certainly affordable, and the immediate shock of the first rounds of sanctions is much more important, as reflected in the weaker ruble, intensified capital flight, and lower stock prices. However, the most important consequences will be felt in the longer term by both the Russian economy and Russian citizens.

The Crimean adventure has shown the world that Russia's economic development and its integration into the global economy are a second-order priority for the Russian elite and can certainly be sacrificed if the regime feels threatened. In the long run, this will undermine investor confidence and remove the plausibility of restoring economic growth in Russia. Russian economic performance may still temporarily improve—for example, in the form of another oil price surge. However, long-term economic growth is unlikely to return, at least until a political transition takes place.

### Notes

This paper is partially based on the Harriman Lecture delivered at the Harriman Institute at Columbia University on February 12, 2014.

1. International Monetary Fund, World Economic Outlook Database, October 2014, [www.imf.org/external/pubs/ft/weo/2014/02/weodata/weorept.aspx?pr.x=80&pr.y=5&sy=1999&ey=2008&scsm=1&ssd=1&sort=country&ds=.&br=1&c=922&s=NGDPRPC&grp=0&a](http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/weorept.aspx?pr.x=80&pr.y=5&sy=1999&ey=2008&scsm=1&ssd=1&sort=country&ds=.&br=1&c=922&s=NGDPRPC&grp=0&a).

2. For detailed analysis of the Russian economic miracle of 1998–2008 and explanations of economic performance during the 2008–09 crisis, see Sergei Guriev and Aleh Tsyvinski, “Challenges Facing Russian Economy after the Crisis,” in Anders Aslund, Sergei Guriev, and Andrew Kuchins, ed., *Russia after the Global Economic Crisis* (Washington, DC: Peterson Institute for International Economics, 2010).

3. Daniel Yergin and Thane Gustafson, *Russia 2010: And What It Means for the World* (New York: Vintage, 1995).

4. For detailed comparisons, see Guriev and Tsyvinski, “Challenges Facing Russian Economy after the Crisis.”

5. Olga Kuvshinova, “Ulyukaev: The Russian Economy Has Likely Entered a Recession,” *Vedomosti*, May 13, 2014, [www.vedomosti.ru/finance/news/26415881/ekonomika-rossii](http://www.vedomosti.ru/finance/news/26415881/ekonomika-rossii).

6. “Peskov: Some Western Countries Act Unscrupulously Trying to Discredit Sochi Olympics,” Tass (Russia), January 23, 2014, <http://en.itar-tass.com/russia/715858>.

7. Vladimir Putin, “Presidential address to the Federal Assembly,” President of Russia official website, December 12, 2013, <http://eng.kremlin.ru/news/6402>.

8. Daron Acemoglu, “Why Not a Political Coase Theorem? Social Conflict, Commitment, and Politics,” *Journal of Comparative Economics* 31, no. 4 (2003): 620–52.

9. Yegor Gaidar, *Collapse of an Empire: Lessons for Modern Russia* (Washington, DC: Brookings Institution, 2007).

10. Guriev and Tsyvinski, “Challenges Facing Russian Economy after the Crisis.”

11. Daniel Treisman, “Presidential Popularity in a Hybrid Regime: Russia under Yeltsin and Putin,” *American Journal of Political Science* 55 (2011): 590–609.

12. Yergin and Gustafson, *Russia 2010*.

# Four Russias and a New Political Reality

NATALIA ZUBAREVICH

The economic and social differentiation in Russia is marked and persistent. In addition to regional differences, we see even more pronounced differences in the quality and way of life and the sets of values among four groups: populations in large, medium, and small cities and in rural Russia.

## Center-Periphery Model of Russian Space: Four Diverging Russias

The basis of the center-periphery model is a hierarchy of dwellings—from the more modernized large cities to patriarchal rural areas.

“**Russia One**” is composed of major cities. The cities with populations of a million or more and those approaching them in size account for 21 percent of Russia’s total population, or 31 percent if cities with half a million residents are included. The proportion of those living in large cities has been steadily rising due to an influx of migrants.

The leaders of Russia One are federal cities with

- A postindustrial economic structure;
- A high level of economic development;
- The highest share of middle-class individuals (30–40 percent of the population<sup>1</sup>);
- Well-educated individuals (in Moscow and St. Petersburg,

39–43 percent of the residents over the age of 15 hold advanced university degrees);

- A larger percentage of residents employed in the small-business sector; and
- High Internet penetration.

It is in the federal cities—particularly in Moscow, where financial and human resources of the entire country are concentrated because of the city's status as the nation's capital—that political transformations have proceeded faster and a growing protest sentiment has been accompanied by demands for government modernization. Electoral data also bear this out: in the September 2013 Moscow mayoral election, the opposition candidate collected 27 percent of the votes, and during the 2012 presidential elections, less than one-half of Muscovites voted for Vladimir Putin.

Postindustrial transformation of the economy and society has proceeded at varying rates in other million-strong cities. Progress has been faster in Yekaterinburg and Novosibirsk, as these cities have the appeal of being macroregional centers in the Urals and Siberia and are also examples of faster transition from the industrial economy to the postindustrial stage. These cities pull in more migrants as they offer more well-paid and modern jobs. The people's social environment and political preferences have been changing more slowly in million-plus-population cities that have kept their Soviet-era industrial specialization, such as Omsk, Ufa, and Volgograd.

Progress has been even slower in cities with a population between 500,000 and 1 million, particularly those with lower education levels and household incomes and with a higher percentage of the workforce employed in the public sector and industry. But even within this group, the differences are large: Tomsk, a university city with a population of 500,000, is well ahead of many larger cities in terms of modernization. Virtually all cities with a population of 500,000 are regional centers, and it helps them concentrate the resources of their respective regions, particularly human resources. In general, the key



factors of modernization are the size of a city and the concentration of human capital there.

But the modernization potential of Russia One should not be overestimated, as the communities in large cities are quite mixed demographically and ideologically. For instance, the share of elderly who heavily depend on the authorities is large (30–33 percent in Moscow and St. Petersburg). The middle class in large cities is also a mixed bag; during the 2000s, the share of bureaucrats, security and police officers, and other public-sector employees (school principals, hospital chiefs, and so forth) grew rapidly. In their case, modernization has been limited to higher consumption standards, whereas their values remained statist and antiliberal and their demand for modernization of institutions minimal.

About 9 percent of Russians live in cities with populations of between a quarter million and a half million people, primarily in regional capitals. In Russia, the capital status of a city makes its social and economic development more sustainable, but its human and financial resources are usually inadequate for modernization. This is an intermediate zone between Russia One and Russia Two, with the situation varying by the city.

**“Russia Two”** refers to medium-sized cities with populations from 50,000 to 250,000 people. They are home to less than 30 percent of Russia’s population. Not all of these cities retained their industrial specialization during the post-Soviet times, but Soviet-era values still hold strong. In addition to considerable employment in the industrial sector, these cities have a large number of people employed in the public sector, most of whom are less-skilled workers.

The economic situation varies across the cities of Russia Two: the highest incomes are enjoyed by residents of oil- and gas-producing cities in the Tyumen Oblast, and incomes are also somewhat higher in cities with large steel and coal industry enterprises—that is, in cities with export-oriented economies. In cities with export-substitution industries (machine building, the food industry, and so forth), wages are considerably lower than in the regional centers. Young people have been fleeing Russia Two for regional centers

where they work or study, and in most cases, they never come back.

Economic crises are particularly hard on one-company cities. There are more than 150 of these, and they account for 10 percent of the country's urban population. During the last economic crisis in 2009, the central authorities financed mass-scale public works, primarily on the premises of the *gorodoobrazyushchie* enterprises (around which one-company cities and towns were built), to maintain employment. Yet a ban on layoffs and on enterprise shutdowns prevented the problem of inefficient employment from being solved. In 2013, economic stagnation brought that problem to the fore again.

The denizens of Russia Two, like the residents of the largest cities, have not been happy with the political situation in this country. During the 2011 parliamentary elections, the share of votes cast in favor of the ruling party (United Russia) in many industrial cities was as low as in large regional centers (29–38 percent). However, during the presidential elections, Russia Two residents voted for Putin because, more than anything else, they valued stability, employment, and wages and remembered well the 1990s, when enterprises would remain idle for long periods of time while workers would go unpaid for months on end.

The main reason for Russia Two to protest is the loss of jobs and wages. The liberal ideas of modernization are unpopular; the greatest value is a strong paternalist state and large-scale social policy. The residents of industrial Russia feel like they are the main “providers” for Russia; therefore, the Kremlin's spin doctors have managed to pit the hardworking populace of Russia Two against the residents of Russia One who, in the language of the official propaganda, “only wag their tongues and produce nothing.” The existence of a political rift is confirmed by the outcome of the presidential elections. In the Urals, during the 2012 presidential race, Putin garnered twice as much support as United Russia received there in the parliamentary election in 2011.

“**Russia Three**” is the traditionalist and very inert rural heartland of most of Russia's regions, as well as the communities in villages and small towns with a population of less than 20,000 (collectively,

more than one-third of this country's population). In these cities, the levels of education and mobility are at their lowest; the public sector and agriculture provide most of the jobs; and a large share of those employed are in the "informal," or shadow, sector. The periphery is apolitical and always votes for the incumbent authorities. In addition, Russia Three has been suffering from depopulation.

The borders between the three Russias are blurred. Obviously, the distribution of the population is not the only factor affecting the pace of modernization, but the center-periphery model helps identify the key differences.

**"Russia Four"** is yet another periphery, which comprises the underdeveloped republics of the North Caucasus (5 percent of Russia's total population) and the south of Siberia (less than 1 percent). These regions differ greatly from the rest of Russia because they are at an earlier stage of the modernization transition: urbanization began later, the demographic transition is incomplete, birth rates remain high, the patriarchal clan-based structure of society persists, ethnic differences are acute, and religion plays an important role.

The rural population is still young, cities have yet to digest the growing migration from the rural areas, and the urban way of life is only just taking shape there. The modernized, urban population is too slow to expand, because a fairly large part of the educated and competitive young people are moving to the country's largest cities. Internally, Russia Four is not homogeneous either: for example, the more urbanized North Ossetia and Adygeya, with predominantly Russian populations, differ in degree of modernization from Chechnya, with its totalitarian regime.

**Divergent Factors.** The center-periphery differences are typical of other countries, particularly those that are catching up in their development. In Russia, these differences have their own specific features:

- A wide gap between the largest cities and the rest of Russia.

- Considerable differences in social and economic development among mid-sized industrial cities geared toward exports and those catering to the domestic market.
- Vast expanses of a deteriorating and depopulating ethnic Russian periphery.

This division into four Russias is based on long-term factors and is very durable, with differences changing very slowly. During the economic boom of the 2000s, the highest rates of growth in incomes and consumption standards were enjoyed by the residents of the largest cities, where the better-paying jobs and the better-educated population are concentrated. Rapid consumption modernization has helped modernize the way of life and the set of values held by the population of the major cities in Russia One. The consumer modernization impetus gradually proliferated from the largest cities to the smaller ones. The 2009 crisis had a stronger impact on the medium-sized industrial cities of Russia Two. On the whole, the gap between Russia One and Russia Two widened in the 2000s.

### **Postimperial Syndrome: The Four Russias Choice**

Until recently, it seemed that Russian nationalism and xenophobia were emerging as Russia's main risks. These phenomena have been gaining ground since the mid-1990s, and the authorities have encouraged them since the late 2000s in an attempt to strengthen their positions. The result was growing nationalism among ethnic minorities leading to social destabilization, which the authorities ignored. These tendencies are still relevant but have temporarily receded, giving way to a different, more powerful way of mobilizing public support—the promotion of a postimperial syndrome.

The phantom pains and frustration after the breakup of the USSR were present in Russian society throughout the entire post-Soviet period, even as nostalgia was wearing off. In 2014, the postimperial syndrome was converted from its latent form into the current open one with the assistance of powerful anti-Ukrainian and anti-Western propaganda. The annexation of Crimea enjoyed massive

public support, and Putin's popularity rating jumped from 60 to 82 percent between January and March 2014. In addition to increased support, the authorities now have an opportunity to attribute the worsening economic situation to malicious designs of foreign enemies. The rising tide of flag waving allows for a tighter policy toward domestic opposition, whom the president has called "national traitors."<sup>2</sup> Political gains which help strengthen the regime are obvious.

Anti-Western sentiments prevail across all four Russias, and restoration of the empire is generally viewed favorably. Survey results suggest that the modernized layer of the urban population espousing European values and rationally perceiving the world is scarce even in the largest cities of Russia. Consumption modernization has not yet changed what Douglass North called "supra-constitutional" values.<sup>3</sup>

It is unlikely that the post-Soviet imperial syndrome will be overcome during the next 10–15 years. Not only has nostalgia for the USSR survived in the minds of the older generations, but also the imperial myth is being successfully reproduced in the minds of Russia's younger people. The period of abrupt intensification of flag waving cannot last long, but support for Putin's policy of, to use the regime's official language, "in-gathering of the Russian lands" is here to stay for a long time as a value choice made by most Russians, no matter where they live.

### **The 2014 Crisis and the Four Russias: Impact and Consequences**

The Russian economy plunged into a recession even before the onset of the crisis in Ukraine. In 2013, there was no growth in industrial output or investment, and 2014 saw the beginning of a serious economic downturn. The growth of household incomes in 2013 was minimal (3 percent) and largely stemmed from wage increases in the public sector. The fiscal position of the nation's regions is deteriorating because of a reduced tax rate and shrinking transfers from the federal budget. The declining fiscal revenues notwithstanding, the regions have to implement Putin's decrees to raise public-sector wages. As a result, 77 out of 83 regions are running fiscal deficits.

In the aggregate, the budget spending by the regions was 8 percent higher than their revenues. Russia's budget is becoming unsustainable, as the regions' debt reached 2 trillion rubles (31 percent of their own revenue net of the transfers from the federal budget). The regions will be forced to cut expenditures, mainly the number of social-sector institutions and their employees.

The impact of the economic woes on the four Russias varies. The underdeveloped republics (Russia Four) did not notice the 2009 economic crisis and are unlikely to notice a new one, since they live mostly off transfers from the federal budget and the shadow economy. The share of these republics in the total transfers to the regions of the Russian Federation is only 10 percent. The federal budget can afford to continue supporting them.

The peripheral Russia Three is also outside the risk zone. It has the largest share of pensioners, and older people are more loyal and manageable even if the rate of pension increases slows down. In rural areas and smaller cities, the share of public-sector and agricultural employees is higher. Wages in the public sector have increased, while the agricultural sector will likely become more competitive on the back of a weaker ruble and declining imports.

The industrial cities of Russia Two have been more deeply affected by the economic crisis, particularly hubs of the steel, coal, paper and pulp, and engineering industries, in which output began to decline in 2013. So far, big and medium-sized businesses have been very careful in their layoff policies because of pressure from the federal and regional authorities, but as the crisis exacerbates, the problem of unemployment will grow more urgent. It may be mitigated to some extent as the federal budget has allocated considerable resources to prop up employment (more than 100 billion rubles in 2014, or 20 percent more than at the peak of the crisis in 2009). But this will help only if the crisis is short lived, which is unlikely given the many institutional flaws of the Russian economy and recent international sanctions in response to Russia's role in the Ukraine crisis.

Russia Two is headed for high unemployment and a drop in living standards. At the same time, it should be taken into account that the populations in the industrial cities in the central, northwestern,

and Urals regions have grown older: most of the workers are close to retirement age, which reduces pressure on the labor market. Wide protests are unlikely, since the population of Russia Two is less educated and will be more easily convinced by the all-out Kremlin propaganda campaign blaming the country's economic problems on scheming foreign enemies.

One-company monotowns are the most vulnerable to the effects of an economic crisis, but a massive public outcry can hardly be expected there. Russia's big businesses have learned how to lower social costs through management tools (like shorter working weeks, mandatory unpaid leaves, minimization of layoffs, reassignment of workers to other tasks within a company if certain shops have to be closed down, firing protest leaders, and a *de facto* actual ban on strikes) and to extract the most benefit from government support for employment. A rather effective alliance between the federal and regional authorities and big business has evolved in Russia, seeking to minimize social protest in industrial cities where large companies have their assets. The medium-sized businesses in monotowns are more vulnerable because the risks of shuttering undermodernized enterprises are higher. (During the 2009 crisis, regional authorities forbade owners of medium-sized businesses to close down unprofitable enterprises, making them work at a loss or sell to new owners; they also forced other companies in the region to buy products from struggling businesses.)

In Russia One, the creeping crisis (or, rather, slow recession) is currently not perceived as an acute problem, but the situation will inevitably grow worse. People in the major cities boast the highest level of education, incomes, and consumption standards and thus have a great deal to lose. The labor market is gradually adjusting to the worsening conditions by freezing wages in the private sector and slowly reducing employment, while households have employed various adaptation strategies. For the bureaucrats, who account for a sizable proportion of the middle class in large cities, the negative impact of the crisis is absorbed by higher wages and corruption rent. Emigration remains an option for competitive professionals who are not willing to adjust to the new political reality.

As the crisis deepens, the residents of Russia's largest cities will be able to shake off the postimperial syndrome sooner and more rationally evaluate the consequences of the Putin regime's antimodernization policies. But whether Russia One has the strength to protest and what the forms and scope of opposition to the Kremlin's policies will be is an open question.

### Scenarios for the Four Russias

Negative political changes in Russia are so swift that predicting anything is extremely difficult. Nevertheless, the general direction of the Putin regime is clear: antimodernization and isolationism. The only question is the depth and longevity of the trend. The new trend in the Russian state's policies has many historical precedents: revolutions have always been followed by periods of counterrevolutions and attempts to restore old development models. In the case of today's Russia, the antimodernization, counterrevolutionary trend is aggravated by the postimperial syndrome. One can think of four development scenarios.

**Back to USSR/Sliding toward Totalitarianism.** This scenario involves switching to the "besieged fortress" mode and tightening the political regime for quite a long time to come. This scenario implies greater control over big business under the threat of nationalization and its subordination to the political interests of the authorities, a mobilization-ready economy, ideological control over key aspects of life, restrictions on foreign travel, large-scale reprisals against the opposition and liquidation of the remaining independent media outlets, and restrictions on the Internet. This likely will lead to a sharp drop in the living standards of the entire population, particularly the middle class in the larger cities who are not part of the bureaucracy. Such a scenario no longer appears implausible, but it is more likely to materialize in the event of a full-scale Russian military invasion of eastern Ukraine and the introduction of sweeping Western sanctions as a response.

Should this scenario materialize, its implications for the four



Russias are easy to predict. The larger cities of Russia One would be hit the hardest, and their population would have to sharply lower their consumption standards. Resistance is unlikely to be broad-based in the repressive environment, but the modernized middle class would leave the country in droves. The differences between Russia One and the other Russias would become smaller because of the shrinking modernization potential of the largest cities.

The authorities would try to mitigate the negative consequences for the industrial Russia Two, which is the Putin regime's political base. Budget-funded government contracts would increase, and so would support for employment in industrial cities.

Russia Three is another base of support for the regime, but in its case, the authorities may limit themselves to maintaining the level of pensions and wages for public-sector employees. The country's outlying areas are incapable of protest and have always voted as expected. Under this scenario, the regime may remain stable over the medium term, while its more distant future would depend on the speed and depth of the economic crisis, which will inevitably worsen even if energy prices do not fall. As a result, Russia would lose almost all of its competitive advantages, except for commodities, and would find itself in the group of less-developed countries.

**Hard Authoritarianism.** Barring a full-scale invasion of eastern Ukraine, this is the most probable scenario. The prevailing anti-modernization trend with the imitation of Soviet practices and pinpoint reprisals against protest leaders will continue. The business community would demonstrate loyalty in exchange for permission to keep their assets, and no considerable nationalization of the economy would take place. The living standards would decline, but not too rapidly. Under this scenario, the educated population of the larger cities of Russia One espousing modern values would self-isolate, withdrawing into "internal emigration" (a passive form of protest), with just a few small groups of active protesters remaining. Emigration would occur on a lesser scale but would be enough to undermine the modernization potential of Russia's largest cities.

Under this scenario, the authorities would also rely on the conservatism of the industrial and still-Soviet Russia Two and the peripheral Russia Three, but it might prove to be a less stable political support than the regime would hope for: after the annexation of Crimea, the mobilization resources based on the postimperial syndrome could be exhausted and the level of political support for the authorities would decline because of economic problems. The Russian authorities then are quite likely to encourage ethnic (Great Russia, orthodox) mobilization and xenophobia toward migrants as a new source of support for the regime which would inevitably exacerbate tensions in Russia Four in the North Caucasus.

In addition to the republics of the Caucasus, the cities of Russia One where the bulk of migrant workers are concentrated and the cities and rural areas of the Russian south where the influx of migrants is also massive would become a problem zone. The consequences of growing Russian and ethnic nationalisms are impossible to predict, and pumping up xenophobia might lead to disintegration of the country as the worst-case scenario. Although the imperial idea unites most of the Russian citizens, albeit temporarily, the national one is sharply divisive.

**Returning to the Modernization Path after a Short Relapse of the Postimperial Syndrome.** This may happen only if the elites split up and later reach an agreement to alter the country's direction and replace the leader, which is unlikely. Even if the course of leadership is changed, it would be difficult to start modernizing institutions and to loosen the state's authoritarian grip on business and society. Regrettably, during the post-Soviet period, particularly under Putin, all the institutions of society, as well as human and social capital, have deteriorated. A change of course in the context of a protracted economic crisis would lead to temporary loss of control and chaotic decentralization. This is virtually inevitable at the stage of abandoning strict authoritarianism.

In this scenario, Russia Two would lose state support; its population would protest but would do so warily because of the low social capital of the industrial cities' population and a limited ability

to act collectively. Russia Three would adjust to the changes using traditional survival techniques (for example, subsidiary farming, picking mushrooms and wild berries, or fishing). Russia One would continue to be the leader of change, but at a much lower level of social and human capital in the largest cities, which would limit the modernization potential.

This potential is further diminished by the fact that the Russian authorities have raised institutional barriers that would impede the progress of Russia One. Thus, a law has been passed abolishing direct mayoral elections in the country's 67 largest cities (excluding the federal centers) to prevent opposition candidates from being elected. In 2012, gubernatorial elections were reinstated, but with a system of filters to prevent the opposition from entering the races. This will enhance the legitimacy of governors, but within the regions the system in which strong mayors of the largest cities counterbalance the regional governors will be destroyed. In the context of weakening federal authority, such an imbalance would facilitate the emergence of authoritarian regional regimes.

To bring this country together, the new Russian authorities would again take a step toward authoritarianism. Russia would again fall in the same pit, confirming the relevance of the path-dependence theory that explains how development is limited by the system of values prevailing in society.<sup>4</sup> These are informal norms and rules deeply rooted in the life of nations and linked to the behavioral stereotypes of large population groups, which makes them stronger than formal institutions (laws).

**Forcibly Toppling the Existing Regime through Revolution.** This is the least likely scenario. The main role under this scenario would be played by Russia One—or, rather, the nation's capital—but the outlines of such a scenario are not discernible for the time being, and its consequences are too harrowing to even contemplate.

### Conclusion

In the post-Crimea political environment, Russia One is an obvious loser. It cannot strengthen its influence on the nation's development by introducing innovative values and diffusing them through the hierarchy of cities. Under the more likely future scenarios, the authorities would isolate Russia One and rely on the conservative semiperiphery and periphery (Russias Two and Three).

Interactions between Russia One and Russia Two are unlikely under any scenario, as their interests diverge in the short and medium term: the residents in major cities are keen to see modernization of the state, while Russia Two values social and economic stability (employment and wages) above anything else.

The problems of Russia Four heighten the risks associated with Russia's development under all scenarios. Under the harshest scenario, these problems may be temporarily frozen with the help of government-sponsored violence, but that would increase development risks further into the future.

### Notes

1. According to a survey conducted by the Independent Institute of Social Policies in 2012.

2. Vladimir Putin, "Address by President of the Russian Federation," Kremlin.ru, March 18, 2014, <http://eng.kremlin.ru/transcripts/6889>.

3. Douglass North, *Instituty, institsutsionalnye izmeneniya and funktsionirovanie ekonomiki* [Institutions, Institutional Changes, and Economic Functions] (Moscow: Nachala, 1997).

4. Ibid.